IS YOUR INSURANCE COMPANY SOLVENT?

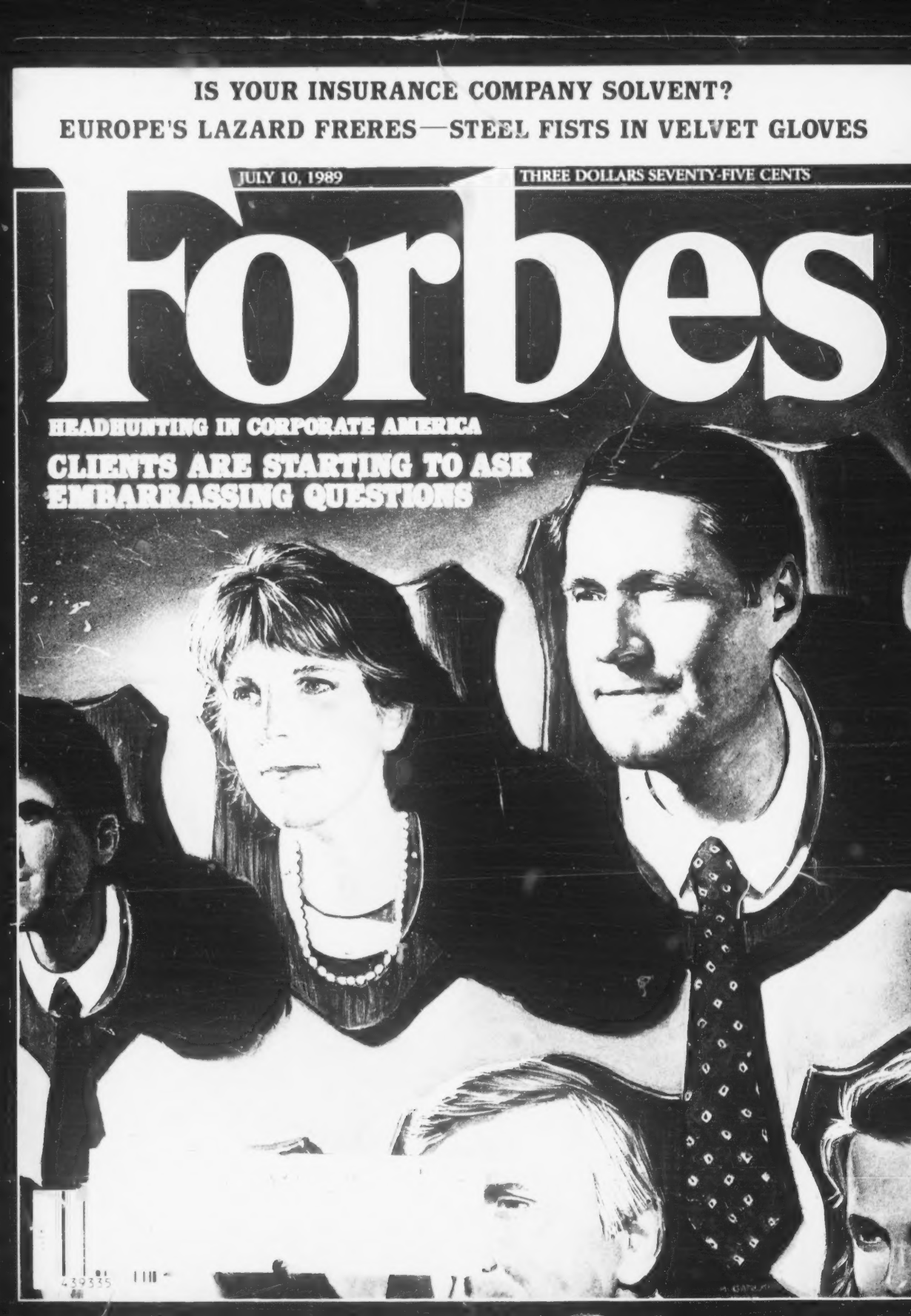
EUROPE'S LAZARD FRERES—STEEL FISTS IN VELVET GLOVES

JULY 10, 1989 THREE DOLLARS SEVENTY-FIVE CENTS

Forbes

HEADHUNTING IN CORPORATE AMERICA

CLIENTS ARE STARTING TO ASK EMBARRASSING QUESTIONS



Forbes

Cover illustration by Michael Garland

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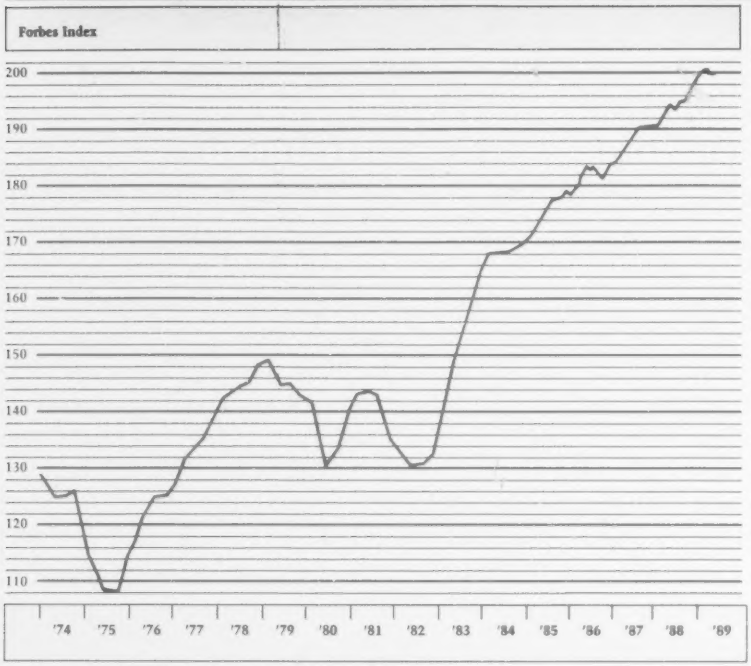
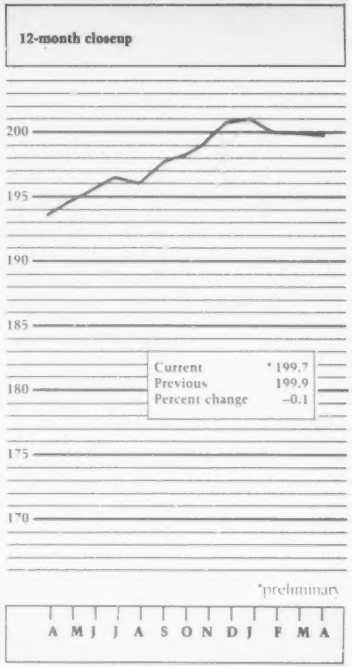
The Forbes Index





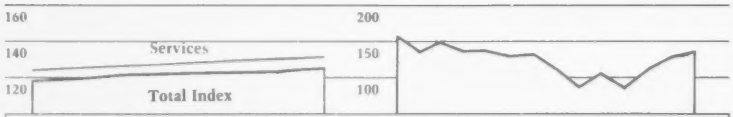
It's not double-digit, but it still hurts. The Consumer Price Index rose 0.7% in April and 0.6% in May. The latest increase was largely the result of higher prices for gasoline and food. At its current pace, inflation is increasing at a 7.4% annual rate. Inflation was 4.4% in 1988.

Industrial production held steady in May, while new unemployment claims jumped 5.6%, the biggest rise in five months. May housing starts gained 2.8%, to 133,100 units, but the trailing 12-month total for this index has been on the decline since February. Consumer installment credit expanded by 0.4%, to a record $693.8 billion, in April. Retail sales rose 0.1% in May, to $141.1 billion.

The Forbes Index Components

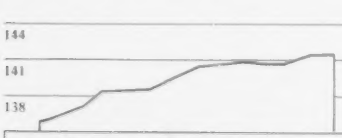
The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, Forbes monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.

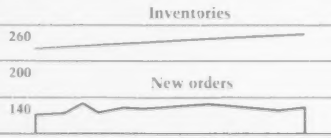


Consumer price indexes (1982-1984 average = 100) all urban consumers, unadjusted (Dept. of Labor)

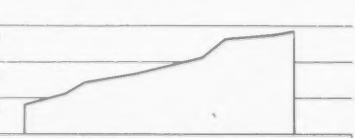
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)



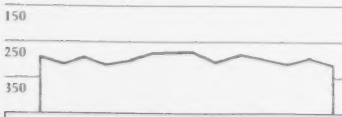
Industrial production index (1967 = 100) seasonally adjusted (Federal Reserve)



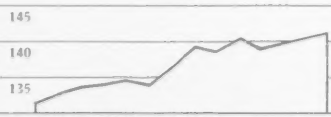
Manufacturers' new orders and inventories ($billions) seasonally adjusted (Dept. of Commerce)



Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)



Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)



Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)

Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)

Forbes

When S&Ls went bad, Uncle Sam bailed out the depositors. But Uncle Sam has made no such promises to life insurance policyholders—and eight out of ten Americans own life insurance.

You bet your life

By Gretchen Morgenson

OF THE 155 MILLION Americans who own some form of life insurance, few are fully aware of the industry's eroding financial base and its rising rate of failures. This ignorance is not bliss. Unlike customers at banks and savings and loan institutions, people who trust their money to life insurance companies are not protected by a federal bailout mechanism.

No, we're not predicting massive failures among life companies, as happened with savings and loans and, to a lesser extent, commercial banks. But only an ostrich would ignore signs of a seriously deteriorating situation.

"The freewheeling approach of some in the insurance industry may put these companies on a crash course similar to the route taken by many of our nation's S&Ls," says Thomas Wheeler, chief executive of Massachusetts Mutual Life Insurance Co., the nation's 11th-largest life insurer. Mass Mutual is widely regarded as one of the sounder companies, and Wheeler is referring to life companies that have been taking excessive risks in their investment portfolios.

Life insurance isn't supposed to be a risky business. But since 1987 some two dozen life insurance companies have defaulted. This marks a sharp departure from the previous two decades, when the failure rate was running at about one life insurer per year.

So far, the failed companies have been relatively small. The annual bailout costs have jumped from less than $9 million in 1982 to about $70 million on average in the past two years. Most of the losses to policyholders have been made good by healthy insurance outfits under various state guaranty fund systems. But if the failures mount, this pro bono publico policy will give way to simple self-preservation.

If the problems were limited to a few highfliers, they could be fairly easily contained. Unfortunately, they are not. The same high-risk strategies and investments that forced some small insurers into insolvency are now nagging some of the big-name life companies like Equitable Life Assurance Society, Travelers Insurance and I.C.H. Corp. Across the industry, balance sheets have weakened dramatically. Five years ago all the life insurance companies followed by the rating agencies were rated Aaa; today only 40% have that top rating, according to Moody's Investors Service.

What are the trouble signs? Perhaps the most alarming is shrinking capital and surplus accounts, meant to cushion against unforeseen risk. One key measure compares capital with portfolio risk. Using 100 as an adequate level of capital needed to compensate for portfolio risk, an index compiled by Moody's shows a steady decline, from 110 in 1984 to 96 last year *(see chart, opposite)*.

Another dicey development is the fact that more and more mutual life insurers are being forced to reduce dividends paid to their policyholders—a clear indication of a profit squeeze. Last year Mutual of New York, with $24 billion in assets, reduced its dividend by 3.5%. Manufacturers Life Insurance Co., with $19.9 billion in assets, has cut its rates 4.3% over the past two years.

It is hardly reassuring to note that many insurance companies are starting to employ questionable accounting techniques to improve the look of

H.B. Lewis

their net capital positions. Late last year, for example, two large life insurers entered into unusual transactions with Citibank. General American Life Insurance Co. of St. Louis ($5.1 billion, assets) and Washington National Insurance of Evanston, Ill. ($1.9 billion, assets) sold Citibank future premiums worth $75 million and $30 million, respectively. These sales had the effect of boosting both companies' net capital positions because the insurers immediately booked as assets the $75 million and $30 million they received from Citibank. But what the bookkeeping entries didn't show was that both insurers had mortgaged some of their future cash flow.

The risks keep rising

Below, insurance companies with above-average problem mortgages—more than 1.2% of invested assets—and junk bonds that exceed 20% of invested assets. Capital and surplus is a cushion against crisis.

Company	Cash & invested assets ($mil)	Problem mortgages as % of cash & invested assets	Problem mortgages as % of capital & surplus
Northwestern National Life	$2,325.5	6.5%	25.6%
Travelers Insurance	24,510.3	5.7	123.8
Mutual Benefit Life	9,614.2	4.4	107.9
John Hancock Mutual Life	23,987.0	3.6	75.3
General American Life	3,772.7	2.5	49.3
		Junk bonds and notes as % of cash & invested assets	**Junk bonds and notes as % of capital & surplus**
First Stratford Life	$632.2	67.0%	2,557.9%
Executive Life of California	10,834.5	54.9	2,913.1
Executive Life of New York	3,648.6	53.1	1,995.1
Presidential Life	1,408.4	35.9	867.7
Fidelity Bankers Life	1,159.4	32.3	940.3

All figures, the most recent available, are as of Dec. 31, 1987.

Source: Conning & Co.

Indeed, a few months ago the New York State superintendent of insurance ruled that the sale of future premiums is really a loan, and so an amount equal to the premium sale should appear as a liability on the insurer's balance sheet. The superintendent found the Citibank deals "inconsistent with statutory accounting principles." But the sales have not been officially disallowed, nor have the insurers restated their financials.

These transactions are nothing more than an effort to mask capital depletions. Without them, Washington National would have shown a $13 million statutory loss in capital for 1988, and General American would have had a $4 million decrease.

The stakes are mounting. The amount of money that changed hands in these transactions was relatively small. But word has it that similar premium sales are being considered by two industry giants, Equitable Life Assurance Society and the Massachusetts Indemnity & Life Insurance Co., a subsidiary of A.L. Williams. Warns Joseph Belth, editor of *Insurance Forum* newsletter, "When these guys begin to play games like this, you may be getting closer to a disaster."

What's behind the balance sheet deterioration? A classic profit squeeze. Life insurance marketing and sales expenses have continued to rise over the past few years, but the nation's increasingly sophisticated consumers are demanding products such as universal life policies and annuities, leaving insurers with slim profits, at best. Gone are the days when simple whole life policies made up the bulk of an insurer's business. Life insurers, pitted against mutual funds and brokerage firms for America's investment dollar, have in some cases resorted to wildly aggressive tactics.

A case in point is Equitable, the giant insurer that got into big trouble with guaranteed investment contracts. Back in the late 1970s and early 1980s, premium inflow from consumers was slowing down, so Equitable took in money to manage from pension funds at huge companies like General Dynamics and General Electric. To attract the business, Equitable—and others—promised higher long-term rates of return than their investment managers could realistically hope to generate.

Other examples are I.C.H., a publicly held Louisville, Ky. company that's big in universal life policies, and Integon, a sizable annuity seller that troubled Southmark agreed to sell in May. Both have seen the quality of their capital bases decline significantly. Knickerbocker Life Insurance, a 70-year-old company out of El Paso, failed in May. The company, which came up $22 million short in receivership, was a big seller of annuities with overly optimistic payout rates.

Low-profit and no-profit products—combined with cutthroat competition—have hit life insurers hard. Nationwide, the industry's returns on surplus capital—roughly equivalent to returns on equity for noninsurance companies—have steadily declined from 15% in 1984 to 9.5% today.

Balance sheets have deteriorated, too. During the 1980s, life insurers invested billions of dollars in junk bonds. Many companies were virtually forced to go for the highest yields because of the guaranteed investment contracts they have been selling. As a percentage of total assets, junk bonds held by most life insurers have more than doubled since 1982. But unlike mutual fund investors, insurance policyholders can't find out if the junk bonds held by their insurance company have increased or decreased in value. Why not? Insurers don't have to mark the value of their bonds to current market prices; instead, they effectively keep them on the books at cost. Result: Even though the principal value in Drexel Burnham Lambert's junk bond composite has declined 5.46% since 1987, insurance companies' junk holdings look as strong as ever—on paper, that is.

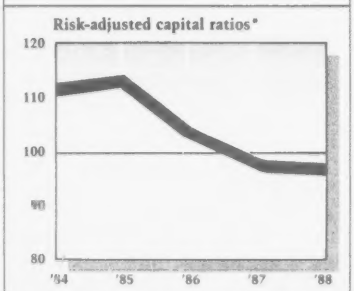
Bad real estate investments are taking a toll, too. But again, life insurers are not forced to mark their real estate assets to market. Still, since 1982, delinquency rates on commercial real estate mortgages held by the nation's top 21 insurers have more than doubled. Foreclosures have quintupled.

For the average policyholder it is difficult to spot these troubling trends. Many industry players—the mutual life insurers—are owned by

Andrew Christie

Capital on the decline

Insurance companies' risks have increased at the expense of their all-important capital.



* Median ratios for 43 leading life insurance companies rated by Moody's Investors Service

policyholders, not stockholders. In effect, they are owned by no one, and management can do as it pleases.

What about the public companies? On Wall Street, stocks of the big life concerns are hitting new highs. Even First Executive Corp., the Los Angeles company run by Fred Carr with 54% of its portfolio in high-risk junk bonds, is trading at nine times earnings, near the high for the year. Monarch Capital is heavily dependent on single-premium life policies, which Congress recently made unattractive from a tax standpoint. Yet, after two years of falling profits, it's trading at 27 times earnings.

Why does Wall Street love the life companies when the road ahead looks so rough? First, large stock companies like Aetna and American Family Life are probably in better financial shape than many of their mutual counterparts. Second, analysts care about immediate earnings growth more than a gradual decline in financial soundness. Earnings, right now, are stable.

Even on upbeat Wall Street, though, there is some skepticism. In 10 of the 14 life companies that Value Line follows, the premium over book that investors have been willing to pay has steadily declined the past three years.

Who will be hurt as more insurers fall out of bed? Policyholders, most likely. There is no federal guarantee fund to back up policyholders' investments. Various states do have guarantee pools, funded by insurance companies doing business in those states. But these are not especially deep pockets. Coverage is generally limited to $100,000 in cash value on a life insurance policy, $100,000 in present value of an annuity. The maximum payout per person is $300,000.

Note: There are no life insurance funds in Alaska, California, Colorado, the District of Columbia, Louisiana, New Jersey, Ohio and Wyoming.

If you live in any of these states or if you own a policy from a company domiciled in these states and your insurer goes under, you'll be just one of the company's creditors waiting to see what you get in a liquidation.

This is a $1.1 trillion (assets) business. Even if only a minor part becomes insolvent, the losses will be huge: An insolvency rate of only 15% among savings and loans created a $305.9 billion disaster.

Because of the federal deposit guarantee, it didn't matter which S&L you put money into, solvent or insolvent. Does it make a difference who insures your life? Darned right, because, if things go bad, you've no assurance Uncle Sam will bail you out. ■

Wall Street's Shearson was very good at what it did. But then it decided to get fancy. Result: mishap after mishap. The latest: the botched Time-Warner deal.

The Peter principle

By Joe Queenan and Tatiana Pouschine

WHEN 36-YEAR-OLD Peter Cohen took the helm at Shearson/American Express in January 1983, he laid out a pair of oversize shoes in front of his office fireplace. The shoes were to be a reminder of his mentor, the legendary Sanford Weill, who had moved up as president of parent company American Express. Figuratively speaking, the shoes still don't fit.

In what appears to be a classic example of overreach, Peter Cohen has inflated a highly profitable retail brokerage outfit into a full-service investment house that does absolutely everything but does not excel in anything. Though revenues have tripled since Weill left, margins have narrowed and earnings tumbled, from $4.34 in 1986 to 81 cents last year. In playing in the mergers and acquisition league, Shearson has seemed out of its class. Fresh from its humiliating failure in backing F. Ross Johnson's grab at RJR Nabisco from its shareholders, Shearson risked even greater embarrassment by watching the Time-Warner merger—in which it assisted Time in its extravagantly parsimonious proposal to shareholders—slip away.

The RJR fiasco, which cost Shearson a potential $200 million in fees, was only the latest in a series of setbacks. Before that, there had been the firing of Boston Co. President James N. Von Germeten after the Shearson subsidiary overstated 1988 earnings by $30 million; Shearson's embarrassing participation in foreign acquirer Beazer Plc.'s hostile raid on Koppers Co.; and the Night of the Living Unbundled Stock Units—a hot concept that quickly cooled off. On top of all this was a $140.7 million (pretax) writeoff of Shearson's holdings in MCorp preferred over the last 18 months, a tepid public response to the Shearson LBO fund and some serious underperforming in limited partnerships.

All of these misfortunes must be viewed with some dismay by Cohen's boss, James Robinson, up at American Express, long rumored to be anxious to part company with Shearson. Even more dismayed are shareholders who bought Shearson at its initial public offering price of $34 in May 1987, only to see it sink to its recent 19⅛ after three straight quarters of losses.

Shearson's current stated book value is $19.19 a share, with capital or equity of $1.7 billion. But when goodwill related to Hutton is eliminated, Shearson's capital shrinks to $300 million, giving it a stated book value of $3.39. By comparison, when goodwill is eliminated from Merrill Lynch's capital, its book value hardly changes from $31.76 a share. This is a particularly relevant item in the securities industry, where a firm's stock price often shadows its book value.

This reduced book value also causes capital problems for Shearson. Moody's released a report in March, raising serious concerns over the adequacy of Shearson's capital, as well as Shearson Holding's use of double leverage. This weak capital structure materially diminishes holding company creditor protection. Moody's expects Shearson to raise new capital.

Yet only nine months ago Peter Cohen was being hailed as a rainmaker—by FORBES along with everybody else. The media regaled its public with stories about Cohen's eccentric attitude toward nicotine (he often sports an unlit cigar), his practical jokes, his

gardening expertise and his austere taste in vehicles.

Cohen seemed to have pulled off a seamless integration of effete Lehman Partners—snapped up for a mere $360 million—and mainstream Shearson, vaulting Shearson from a highly profitable but specialized brokerage to a close second to Merrill Lynch as an integrated investment house.

Then, Cohen won kudos by assimilating the gunslinging E.F. Hutton crowd into his tamer Shearson Lehman hybrid. With Shearson's revenues rivaling those of Merrill Lynch and the firm's merger & acquisition business really starting to percolate—it was near the top of the heap for the first half of 1988—Cohen seemed to have arrived.

Doubts about Cohen's performance did not arise until Kohlberg Kravis Roberts blew Johnson/Cohen out of the water with its successful bid for RJR Nabisco. By trying to abscond with the company for $8 billion less than it ultimately proved to be worth, Johnson became, in the words of the *Wall Street Journal*, a "symbol of greed." Indeed, Johnson's cupidity was apotheosized when the deal appeared on the cover of *Time*. Thus, it is ironic that the next time Shearson should surface with a bunch of guys trying to hose shareholders, its client should be the parent of that very same magazine. It was no big deal for Paramount Communications' Martin Davis to top the Shearson-orchestrated bid by a neat $75 a share. No cover story this time.

In assessing Shearson's recent history, one gets the impression that Cohen lives off momentum: If he can just keep the company moving in enough directions, it will eventually find the right one. This reckless fidgeting was on display during Beazer's $1.7 billion hostile bid for Pittsburgh-based Koppers in the spring of 1988. That's the deal in which Shearson not only offered to put up a $570 million loan but also agreed to throw in another $25 million to buy 11% of the target if the deal went through. Thus, a formerly traditional investment bank was going to act as a principal in a hostile takeover. Corporate America raised a collective eyebrow.

Shearson's behavior so annoyed former Pennsylvania Treasurer G. Davis Greene Jr. that he announced that the state, which had reportedly done $7 billion worth of commercial paper with the firm the previous year, would suspend its business with Shearson. Meanwhile, Koppers executives were leaving home without their American Express cards, having already mutilated them with scissors and other implements. Robinson must have viewed all this with horror.

The zeal to deal may have also led to the departure of Stephen Waters, cohead of M&A, who was apparently not too thrilled by Shearson's chumminess with raider Paul Bilzerian, convicted in June by a federal court of securities and tax fraud. After Shearson, possibly at AmEx' behest, cooled toward the more aggressive types, Daniel J. Good, the banker who had brought Bilzerian into Shearson, left about a year later. Waters is now at Morgan Stanley, Good has formed his own firm and Bilzerian is bound for points unknown but probably won't be needing any M&A help for a while.

Back in the days when he was still a hero, Cohen proved adept at raising money. In April 1987 he persuaded Nippon Life Insurance to purchase 13% of Shearson for $508 million, and Shearson added to its war chest with a May 1987 IPO, selling 18 million shares for $612 million.

When the dust had cleared, American Express had reduced its stake to 62%, and rumors persist that it would love to move to a minority position to remove the increasingly unsightly Shearson numbers from its books.

Had Shearson used the money it got from the Japanese to strengthen its capital position, nobody would be raising questions about its capital position. Alas, it did not squirrel the money away. It used $962 million, excluding assumption of Hutton liabilities, to buy the battle-scarred E.F. Hutton, a chiefly retail house. That was $29.25 a share in cash, or a manly three times Hutton's book value, at a time when Wall Street's retail trade was going into a swoon from which it has not recovered. (Thomson McKinnon is said to have agreed to be sold at about half its year-end 1988 book value.)

The purchase was clearly an attempt to put Shearson on the same plane as titan Merrill Lynch, which it has. Shearson's 1988 revenues were $10.5 billion, exactly the same as Merrill's.

But the expansion was at the expense of profits. When Cohen took over direct control of Shearson in 1983, its net margin of 10.8% was one of the highest in the business; Morgan Stanley's was 10.9%. Since then, Morgan's margins climbed to an enviable 17.9% in 1988, while Shearson's eroded to 5%, if one excludes the one-time Hutton-related writeoff of $165 million. Counting it in, its margin had shrunk to a miserable 2%.

Jodi Buren

Peter Cohen with his trademark stogie
The Shearson story is little capital, even less earnings.

A less macabre, but no less telling, faux pas than the Hutton acquisition was Shearson's recent experiment with an innovative financial product. Last winter Shearson announced the introduction of a labyrinthine thingamajig called "unbundled stock units." Fusing actuarial wizardry with esoteric antitakeover potential, the gimmick initially captured the attention of The Street, which deemed the units "exciting," "innovative" and "unusual" before finally settling on the definitive term: "stupid." Shearson, which had been predicting that its clients would exchange $5 billion of common stock for the new units, earning Shearson perhaps $95 million in the first quarter alone, again seemed to be rushing off half-

Is the price right?

Shearson isn't the only adviser to underprice, but Time Inc. is a whopper.

Target	Target's investment banker(s)	Bidders	Status	Price/ share	Premium[1] (%)	Value of offers ($mil)	Under-valuation ($mil)
Time Inc	Shearson Lehman Hutton	Warner Communications[2]	Agreed mrgr	$98.67[3]		$6,019	
	Wasserstein Perella	Paramount Communications[2]	Higher bid	175.00	77%	10,700	$4,681
Champion Spark Plug	Dillon, Read	Dana Corp	Agreed bid[4]	17.50		604	
	Kidder, Peabody	Cooper Industries	Higher bid	23.18	32	800[5]	196
SSMC Inc	Morgan Stanley	Intl Semi-Tech (Canada)	Agreed bid	30.00		220	
		Intl Semi-Tech (Canada)[6]	Higher bid	38.00	27	284	64
Pullman Co	Shearson Lehman Hutton	Management-led group	Agreed bid	7.75		325	
		Forstmann Little	Higher bid	9.25	19	388	63
Irving Bank	JP Morgan	Banca Commerciale (Italy)	Agreed bid	65.00		1,224[7]	
	Goldman, Sachs	Bank of New York	Higher bid	77.00	18	1,450	226
JP Stevens	Kidder, Peabody	Odyssey Partners	Agreed bid	61.50		1,077	
	Goldman, Sachs	West Point-Pepperell	Higher bid	68.50	11	1,200	123
Insilco	Goldman, Sachs	CS First Boston & management	Agreed bid	29.00		724	
		INR Partners	Higher bid	31.75	9	813	89
Federated Department Stores	Shearson Lehman Hutton	RH Macy	Agreed bid	68.00		6,100	
	Goldman, Sachs						
	Hellman & Friedman	Campeau (Canada)	Higher bid	73.00	7	6,540	440
Macmillan Inc	CS First Boston	Kohlberg Kravis Roberts	Agreed bid	85.00		2,363	
	Lazard Frères	& management					
	Wasserstein Perella	Maxwell Communication (UK)	Higher bid	90.25	6	2,640	277

Note: RJR is not included because it formally agreed only to KKR's offer. [1]Difference between higher and agreed bids, as percentage of agreed bid. [2]Transactions are pending. [3]Under Warner merger. Time is valued by applying the stock swap ratio to Warner's market price of $45.88/share on 3/3/89. [4]In all cases, agreed bid is the first price obtaining target's agreement. [5]Includes $15 million termination fee paid to Dana. [6]Company topped its own agreed bid after Berjaya Corp. (Malaysia) offered $37/share. [7]Irving backed BCI's 4/19/88 offer for 51% of Irving, giving it an imputed value of $1.2 billion.

Source: The World Deal Review, published by New York-based investment banker Translink International.

cocked. On closer examination, the units didn't make sense (FORBES, *Feb 6*). Says Shearson President Jeffrey Lane, "The firm encourages employees to take risks."

If the stock units were poorly thought out, Shearson's Time-Warner deal was byzantine. So much so that even the arbs, the most cunning predators of all, were confused. On Mar. 6, the Monday after the Time-Warner deal was announced, most arbitragers accorded the traditional takeover premium to Warner, not Time. Time, which was being acquired, closed down $1.63, at 107½, while Warner closed at 48¼, up from 45⅞ the Friday before. Time shareholders would own only 38% of the combined entity. It wasn't until the next day that the market caught on to the fact that Time was being acquired, sending Time shares up 9¼ points in one day. Some arbs lost a bundle in unraveling their positions.

When the market finally caught on that Time was the acquired, it didn't take long to figure out that it was being acquired at a very low price. Betting on other bidders, traders sent Time's shares to a high of 135½ by May 30. Then Paramount put a $175 cash offer on the table. With that offer the bidding wasn't even close, suggesting that Shearson's pricing was so low as to be self-defeating. Shades of RJR.

Currently, the proposal is for Time to take over Warner, adding on an estimated $9 billion to $14 billion of debt. In an acquisition, shareholders don't vote.

In a bitter irony, it was Waters, Cohen's ex-M&A wizard, who ended up at Morgan Stanley backing Henry Kravis in his campaign for RJR against Shearson and Ross Johnson. He is also behind the Paramount bid. The winners of RJR took home millions; Shearson was barely reimbursed for its expenses.

But RJR and Time Inc. aren't the only two instances where the market rescued Shearson clients. Last year, thanks to higher bids, Pullman was sold for $63 million more than Shearson's agreed price (a 19% premium) and Federated Department Stores, which netted Shearson about $20 million in fees, was proved to have been $440 million undervalued *(see table, above)*.

Shearson, and the dauntless analysts who remain in its corner, argue that much of this unpleasantness is the inevitable hiccups associated with digesting entities as large and unwieldy as E.F. Hutton. PaineWebber's Brenda McCoy explains that if one throws out such nonrecurring items as the $165 million Shearson paid out to digest its Hutton acquisition or the MCorp writedown, the firm is now poised for earnings growth.

But much of that

The defense business

Shearson ranks low, relative to the competition, in the number of takeover targets it advises and the size of assets at stake.

Adviser	Value of deals ($bil)	Number of deals latest 12 mo*
Lazard Frères	$47.5	5
Dillon, Read	31.8	3
Merrill Lynch	29.6	2
Goldman, Sachs	19.9	15
CS First Boston	16.3	11
Wasserstein Perella	8.4	2
Morgan Stanley	7.6	7
Drexel Burnham Lambert	6.9	3
Shearson Lehman Hutton	6.0	3

*U.S. deals over $100 million announced after May 31, 1988 and completed before May 31, 1989.

Source: The World Deal Review, published by Translink International, New York.

growth will have to come from the M&A business, and here the record is humiliatingly grim. Cohen had little experience in investment banking before the Lehman acquisition, but he figured bringing in the top guns from that venerable house would resolve that deficiency. But one of the astonishing revelations of the past three years is that you don't need a huge infrastructure to be a successful investment bank. It's people that count, and not that many of them, so long as the people running the show are smart (KKR), well-connected (Pete Peterson) or both (Wasserstein & Perella).

Since the beginning of the year Shearson has placed fourth among the eight largest investment banking houses in announced mergers, but dead last in completions. And the big fees—and bonuses—come when the deal closes. Investment banking fees were a third lower this quarter compared with last, nosediving from $357 million to $243 million.

Shearson's M&A chief Tomlinson Hill responds that his department doesn't get enough credit for its defensive work. In fact, Shearson now ranks ninth in the target adviser business *(see table, p.42, bottom)*

One reason Shearson may be having trouble developing investment banking is that it's losing key people at a rate high even for Wall Street. One former Shearson Lehman banker says that out of the 18 people who started the same year he did at the combined entity, only 4 or 5 remain. The Lehman stars, among them Steve Schwarzman, Roger Altman, Peter Solomon, Steve Waters, Eric Gleacher, are all history. Some left almost immediately; others checked out shortly after bonus time in February.

In what would appear to be a spillover effect, Shearson has been having trouble with its LBO fund, known as merchant banking partnerships. Launched last year, the fund started out with a target of $1 billion, but then reportedly got frisky and counted on $1.8 billion. Shearson collected $1.4 billion, with about half of that coming from employees and its major shareholders.

Are there any bright spots on the Shearson horizon? Yes. The trading floor seems to be a steady revenue producer. And if the stock market continues to climb, and the retail consumer loses his fear of flying, Shearson has the infrastructure in place to make hay. But for every bright sign, there is a countervailing negative. A hefty chunk of Shearson's limited partnerships are in serious trouble, particularly those involving real estate. And despite all the talk about restructuring costs, fixed costs are a continuing drag on earnings.

Cohen, who has bet the farm on feverish growth, may soon have to face the music because there is no more money to spend on acquisitions. To acquire Hutton, Shearson leveraged itself into the heavens: At the end of 1988 its long-term debt-to-equity stood at 4-to-1, compared with Merrill Lynch's 2-to-1. In March, Shearson sold AmEx a mutual fund back-office business, once part of the Boston Co., for $275 million, to raise more capital; the $200 million net gain on sale went straight into Shearson's capital accounts, bypassing the income statement. Rumors persist that other Shearson businesses will soon be sold. This makes sense were Amex to sell Shearson in the traditional way to the public, it might have to take a $350 million hit.

Back in the days when Weill and Cohen were running Shearson, they prided themselves on close attention to detail and an almost fanatical watch on expenses. They were both very much operating men. These days Cohen takes care of the vision thing, frequently jetting overseas, while Lane, who started out as Cohen's research analyst sidekick, supervises day-to-day operations.

In fact, when FORBES visited Shearson's headquarters, Cohen, cigar and all, shared our elevator. FORBES was on its way to talk business with Hill; Cohen was getting off one plane from Europe that morning ready to take another one that night. FORBES had hoped he was there to talk to us, but maybe he'd just stopped by to see if those shoes had shrunk. ■

Whether Time gets Warner or Paramount gets Time, the victor will end up with its earnings devastated. Does that matter?

A peculiar beauty contest

By Dana Wechsler

WHOEVER WINS Time Inc., the contending bidders have done more than put a company into play. They have also focused attention on an interesting accounting question, namely: Does anyone care about a company's reported earnings anymore?

Paramount's Martin Davis conceded the deal would result in Paramount's earnings being "significantly lowered." But he, in effect, added: So what? Cash flow, not earnings, is the name of the stock valuation business these days.

The issue here is goodwill. Most of the big takeover deals are being done at huge premiums over book value—in Time's case, Paramount is offering $175 for a company whose book value is $24.75 a share. Most of the $150 premium would be carried on Paramount's books as goodwill, and accounting rules say that goodwill must be written off over up to 40 years.

If it wins Time, Paramount will end up with close to $9 billion in goodwill, requiring annual amortization of $225 million. This amortization would come straight out of aftertax profits. Add to that the interest cost of the enormous amount Paramount would need to borrow to handle the deal, and the acquisition would cost Paramount a great deal more than it brings in. Time Inc.'s earnings last year were only $289 million.

Without Time, Paramount's 1989 earnings would be about $415 million, $3.50 a share. The acquisition might reduce Paramount to breakeven so far as reported earnings are concerned.

Why should goodwill be amortized?

Executive recruiters—headhunters to you—have come to believe their own propaganda about high fees and sophisticated search techniques. In fact, the whole industry may be riding for a fall.

The clients are restless

Lester Korn, chairman of Korn/Ferry International
Call him Mr. Ambassador.
Alan Levenson

By Dyan Machan

"ARE YOU READY to meet the ambassador?" asks the pert blonde secretary. Is FORBES in the presence of a diplomatic notable? Hardly. We're calling on Lester Korn, 53, chairman of Korn/Ferry International, the U.S.' biggest executive headhunter. *Ambassador* Korn? Well, Lester Korn was U.S. representative to the Economic and Social Council of the U.N. from 1987 to 1988. That's a relatively minor post, not the sort that carries a title into private life. But then Lester Korn is in a business where appearances sometimes matter more than realities. So "Ambassador" Korn it is.

Headhunters like Korn have amassed enormous clout in American industry. They have helped anoint the heads of Apple Computer and Black & Decker, among others. Some 1,200 recruiting outfits last year competed for $2.5 billion in fees and expenses, a full third of it going to the top 10 firms. Korn's outfit alone took in $88.6 million. With restructuring and reshuffling the order of the day in the 1980s, demand for headhunters' services has skyrocketed.

But even as the business prospers, its reputation is becoming tarnished.

Conflict of interest, for example. If a client hires a search firm to find, say, a new chief financial officer, the search firm generally agrees that it will not raid that client for at least two years. That means the largest firms—those with the most clients—are handicapped in doing the very job for which they are hired.

Examples: Korn/Ferry, because of past relationships, is restricted from approaching 2,150 corporate entities. The nation's second-largest search firm, Russell Reynolds Associates, admits that 1,567 outfits are off-limits.

This can cause real problems for the clients. Korn/Ferry was retained about two years ago to find a new divisional president for Greenman Brothers Inc., a toy company based in Farmingdale, N.Y. What Korn/Ferry didn't tell Greenman Brothers was that its client list already included Toys "R" Us, Child World and F.A.O. Schwarz; just about all of the major toy players were out of bounds. With hardly any place to look for candidates, the search fizzled. Greenman Brothers ended up paying Korn/Ferry a hefty fee and then filling the job itself by luring back a former employee.

To get around this ban on raiding their own clients, some executive recruiters sometimes cut corners. Lawrence Holleran, human resources vice president for Chicago's FMC Corp., recounts how SpencerStuart, the nation's number three search firm, once tried to spirit away an FMC headquarters executive just months after completing a search for FMC's Brazilian subsidiary. Holleran confronted SpencerStuart, but the firm told him that its Brazilian search meant only that FMC's Brazilian division was protected from talent raids.

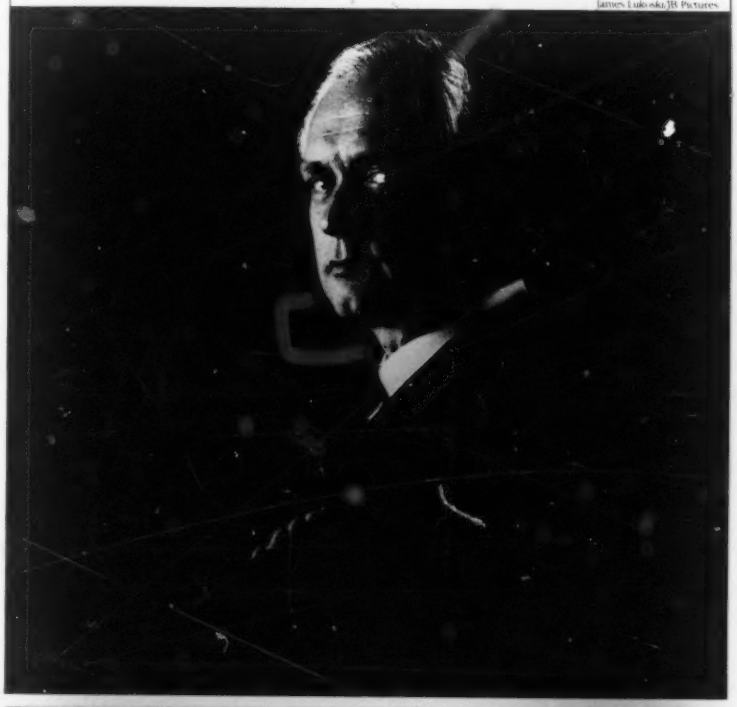
Today Holleran doesn't use SpencerStuart, and when he does use other search firms he makes sure to get a guarantee that all of FMC Corp. will be off-limits. Emerson Electric Co. reports similar problems and a similar solution: no more search firms without two-year, companywide protection.

Why don't companies approach their candidates themselves? It is considered unseemly for corporations to pick off the best talent from their competition but quite acceptable to hire a headhunter to do the stealing for them. Therein lies the source of the search industry's power.

The high and rising cost of executive searches is also causing increased customer resistance. "You don't get your dollar's worth," complains Mark Naster, recruiting and placement di-

Kent Kroeber, Interpublic's senior vice president for human resources
Steering clear of the largest firms.

James Lukoski/JH Pictures



Laurence Holleran, FMC's vice president for human resources
Nowadays he demands companywide protection.

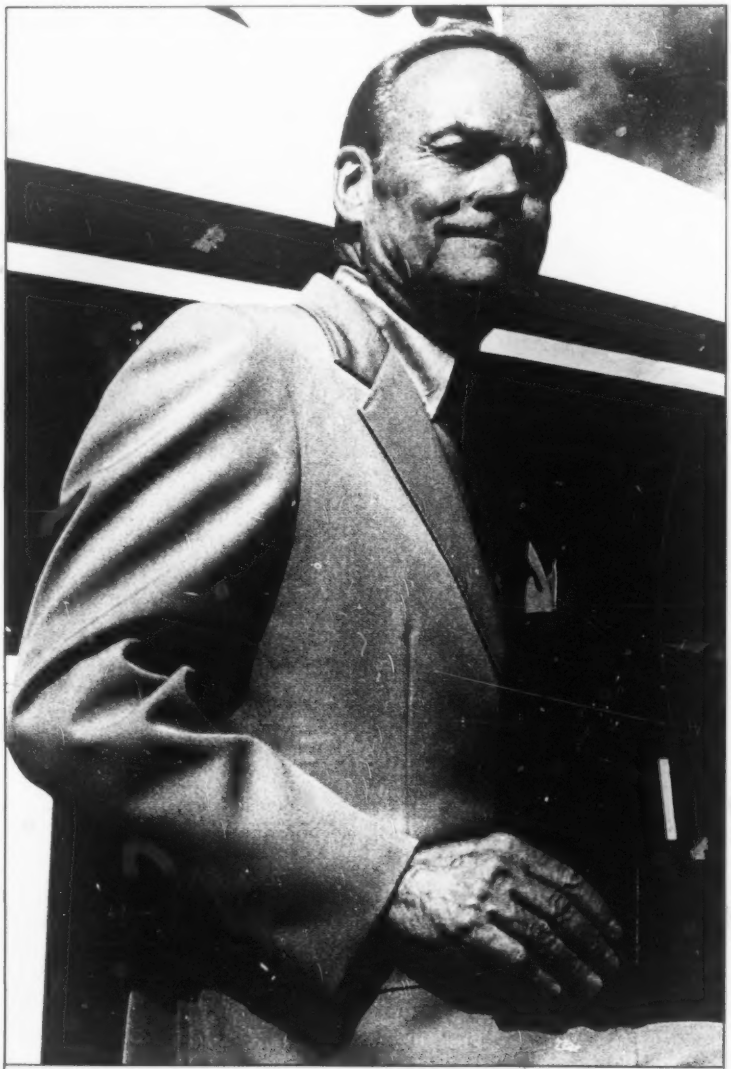
Steve Leonard

rector at Marion Laboratories in Kansas City, Mo. Thirty years ago search firms charged fees equal to 15% of a recruit's first-year salary and bonus. By the early 1970s executive search caught on and recruiters were able to hike their fees to 25% of salary and bonus. Then, in the early 1980s, with corporate loyalty out of fashion and demand for executives robust, fees inched up to 33.3%.

Yet the customers paid.

Executive reshuffling continues apace these days, but it is also a time when business is watching costs carefully. Many executive search clients, therefore, are beginning to question the fee structure openly. Many conclude that the biggest headhunters offer few real advantages over doing searches themselves or hiring smaller headhunters.

One dissatisfied customer is Kent Kroeber, senior vice president for human resources at the Interpublic Group of Companies, Inc. He now steers clear of the big firms, usually doing his own search work or hiring smaller, specialized recruiting outfits. Says Kroeber, "I am appalled by the larger firms' slick brochures and their graduates from fine universities—it's all just adding to their overhead." Complains Larry McClure, director of executive resources for United Technologies: "There is a continual effort to try to make their [executive recruiting] business more complicated than it really is. It's like putting fuzz on a grape."



Michel Setboun/TB Pictures

William Houze of William C. Houze & Co.
He got tired of "paying country club bills."

Is bigger best? The big recruiters have carefully fostered the legend: A big firm has more offices, more recruiters, more coverage. A lot of the clients have decided that this is an expensive myth. "Except in the rare case of needing an executive in East Africa, there's little argument for all the multinational offices," says James Kennedy, publisher of *Executive Recruiter News*. Interpublic's Kroeber doesn't buy the far-flung empire bit, either: "The broader the search, the higher the cost. It's just another way to run up expenses."

Even in the case of nationwide searches, there is often little synergy among a search firm's various offices. Recruiters are largely an independent bunch, busy looking for their own job candidates and their own commissions. The largest firms usually run their offices as separate profit centers, giving little incentive for one to help another. An estimated 90% of searches are completed regionally. Listen to Don Allerton, an executive recruiter at Chicago's smallish Allerton/Heinze, who was formerly with Staub Warmbold, a medium-size firm. He says of recruiters in general, "We don't talk to the guy next door, much less to the guy in Tokyo."

What about the much-vaunted computer search capability? Each of the top firms touts its state-of-the-art database. In reality, these databases are little more than computerized collections of résumés that can include the names of dead people, incompetents and job jumpers. Korn/Ferry insists that some 25% of its final placements come from its database, but a majority of the recruiters contacted for this article insisted that they have never made a single placement from the computer. Says John Plummer of Ward Howell International: "I work with it because it's there, but does it help to fill a post? Absolutely not."

Another sore point: Many clients are disturbed to discover that the polished consultant they first met is not the person doing the actual work. Early on, the big search firms discovered they could save money by letting their Ivy League front men contact clients, all the while passing the actual work to an army of back-office researchers. Although an accepted practice in other professions, this angered Mark Naster of Marion Labs. Naster met with a Korn/Ferry representative for hours, explaining in painful detail what he wanted in an associate medi-

cal director. When none of the candidates was acceptable, Naster was irate: "The Korn/Ferry guy was too busy selling accounts to come up with good applicants."

Searches often end up costing more than you might expect—not just because of the 33.3% lump sum but because of all the extra fees that are added on. Korn/Ferry, for example, tacks on additional charges for messenger service and secretarial time. This comes on top of more commonly billed extras such as long-distance telephone calls, entertainment and travel. Has anything been left out? Just in case, at the outset of a search, Korn/Ferry charges its clients a $300 setup fee.

Gardner Morris, a human resources manager at Raytheon Co., once asked for a breakdown of a bill submitted by a medium-size search firm. On the itemized version he found his name listed next to a $265 lunch he never ate, at a restaurant that he had never visited.

With many companies turning sour on big search firms, the smaller search firms are gaining some ground. Often the smaller firms charge lower fees. One example is Harris Heery & Associates, a Norwalk, Conn.-based specialist in placing marketing executives. Harris Heery charges a 30% fee instead of the usual one-third. What about add-on charges? "We wouldn't think of passing on our own overhead like that," says Andrew Harris, the firm's cofounder. "I make plenty of money doing what I do."

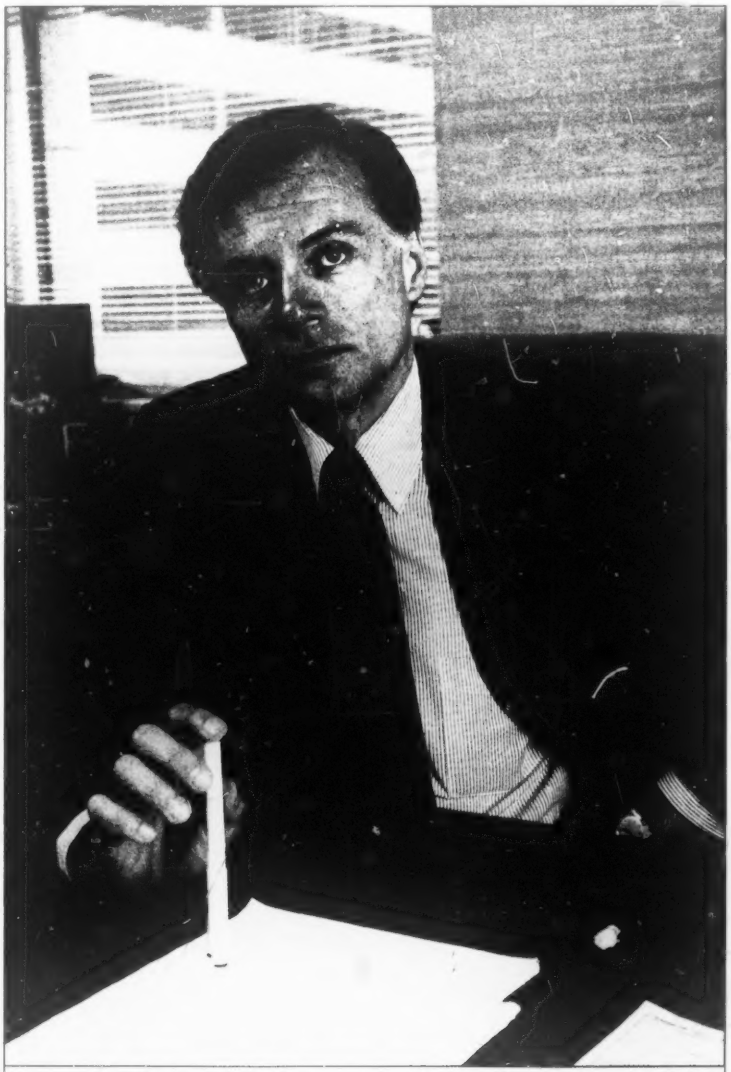
But, riding high, many top recruiters dismiss out of hand these signs of client unhappiness over fees. Russell Reynolds, 57, the founder of the headhunting firm that bears his name, argues that if investment banking firms and law firms earn multimillion-dollar fees, so should executive recruiters. Reynolds says he has been undercharging his clients for years. He and Korn are mulling a fee increase to perhaps 35%. Reynolds argues that over several years an individual recruited by his company may see his income rise sharply; now he would like to go after a piece of that action. What if a job candidate bombs out and is fired in six months? Would Reynolds consider refunding the 33.3% fee? No way.

In fact, there is something illogical about fees based on a percentage of first-year salary. Headhunters admit that, generally speaking, the higher the salary, the easier the search. Case in point: Did Kohlberg Kravis Roberts & Co. really have to pay Spencer-Stuart an estimated $650,000 to recruit American Express Co.'s Louis Gerstner Jr. to run RJR Nabisco? Wouldn't a telephone call from Henry Kravis to Gerstner have done the job?

A more logical approach would be to charge an amount directly related to the complexity of the task. One of the very few firms that bill clients this way is Egon Zehnder, a leading European search firm that has risen to become the 11th largest in U.S. headhunting. Egon Zehnder estimates the amount of time required, and charges accordingly.

A small Los Angeles-based firm is taking Egon Zehnder's policy one step further. William C. Houze & Co. charges a fixed fee that includes all of its overhead—no extra expenses are tacked on to the final bill. Houze, 67, devised this approach after working on the other side of the fence as a human resource director at General Electric and Rockwell International. Houze felt that the recruiters he had dealt with were overcharging. Says Houze, "I got tired of paying country club bills." So far, companies such as General Electric Radar and Fairchild Industries have responded favorably, hiring him to do several of their searches.

Marion Labs says it has negotiated headhunters' fees down to 25% of first-year salary and bonus, from



Don Allerton of Allerton Heinze Gregory Gayton

Don't be fooled by the far-flung empire pitch.

Russell Reynolds of Russell Reynolds Associates
What if a job candidate bombs out? Would Reynolds consider refunding his fee? No way.

33.3%. Many companies are starting to ask for flat fees, and in some cases the large search firms are complying. What choice do they have? In addition, clients are finding that they can avoid paying overhead charges by simply ignoring them. Says Interpublic's Kroeber, "When I get a bill for expenses, I throw it out. So far, I've been getting away with it."

Toyota has taken a different tack. The company hired search firms to fill one of its top U.S. parts positions but struck out three times. Two candidates left after short stints on the job. Particularly frustrating, one search effort didn't even come up with a suitable candidate.

All this left Toyota with no parts manager and three headhunting bills that totaled more than a year's salary for the post. Now the carmaker withholds the last third of a recruiter's fee until a job candidate joins the company.

Arrangements like Toyota's are becoming more common.

Besides haggling for more realistic fees, many clients are beginning to do more search work themselves. It's becoming easier because they can actually buy databases similar to the ones the large search firms tout so aggressively. Human resource directors say the databases are not a panacea and add that the databases rarely spit out the names of wonderful job candidates. More often, the databases—especially those that are tailored to specific industries—are used for leads.

In the past four years at least 120 new companies have cropped up selling lists of resumes in a variety of fields. This do-it-yourself trend will likely continue.

These have been glory days for the nation's headhunters. The business will go on because it does, by and large, perform a service despite the exalted claims and inflated charges. But the glory days, the days of easy money, are probably over. ■

The top four

At the biggest search firms, revenues have jumped sharply. With growth has come arrogance, inflated fees, and potential conflict of interest: The more clients a headhunter works for, the fewer places he can recruit.

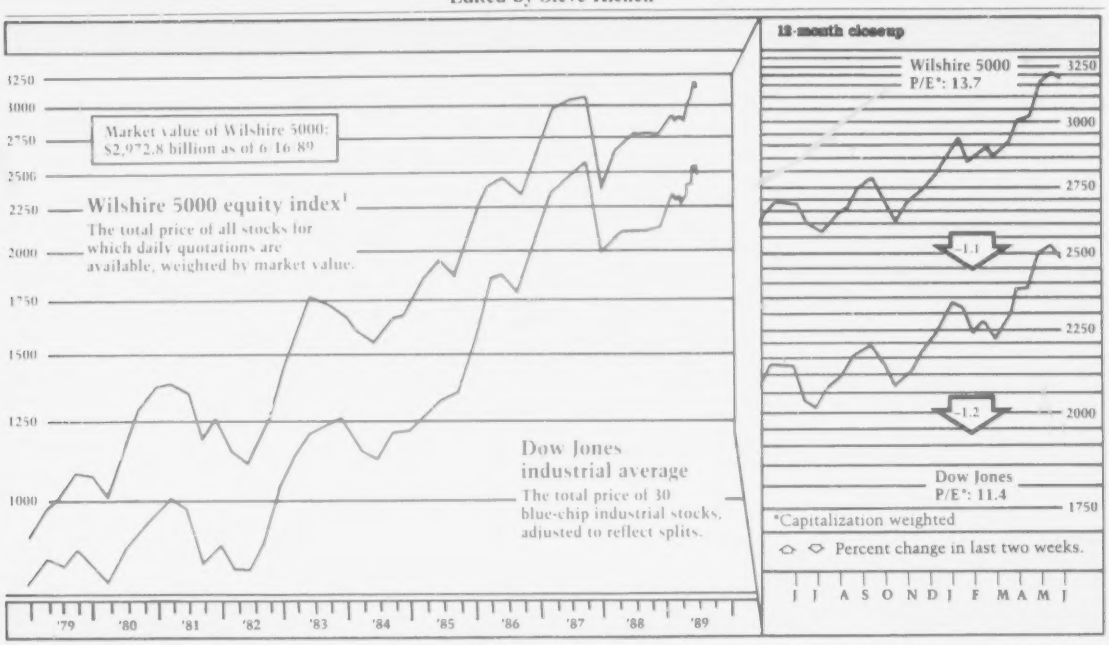
Firm	Offices	1988 fees U.S. ($millions)	1988 fees outside U.S. ($millions)	Clients off-limits
Korn Ferry	43	$56.4*	$32.2*	2,150
Russell Reynolds	21	49.3	28.9	1,567
SpencerStuart	30	30.0	36.5	1,250
Heidrick & Struggles	23	31.3	16.8	1,289

*April fiscal year; all others calendar year

Source: companies, Kennedy Publications

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen



Resistance at the 2500 level. In the last two weeks the Dow industrials slipped back to 2486—down 1.2%. Since the start of the year, however, the Dow shows a 14.7% gain, the Wilshire index a 15.9% gain. According to Stephen Leeb, editor of *Indicator Digest*, "The recent downturn in long-term yields means that a recession is as elusive as ever." Leeb adds, "There has never been a major market correction or economic recession when bond yields are declining."

A strengthening dollar may have encouraged investors to take profits during the last two weeks. A stronger American currency will make foreign goods more competitive and reduce the dollar-denominated earnings of U.S. multinationals. On the positive side, takeover targets such as Time Inc. and NWA probably dampened selling activity. Consumer nondurable and transportation shares, with declines of 0.7%, show the smallest two-week losses. The Wilshire index fell 1.1%.

Closeup On the Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[2]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	0.5	0.2	–0.6	0.4	2.3	1.2
in last 52 weeks	17.7	17.2	18.2	17.5	18.4	15.6

Stock performance based on six key investor yardsticks[3]

Percent change	Company size		Volatility[4]		P/E multiple		Dividend yield		Growth profile[5]		Share price	
	large	small	high	low	over 21	under 8	over 4.5%	none	high	low	over $34	under $5
in last 4 weeks	1.0	3.4	1.1	2.0	1.5	2.6	2.5	1.8	1.7	1.5	1.3	3.2
in last 52 weeks	19.9	22.0	13.2	10.5	27.6	15.3	6.0	23.0	16.9	15.7	22.7	6.4

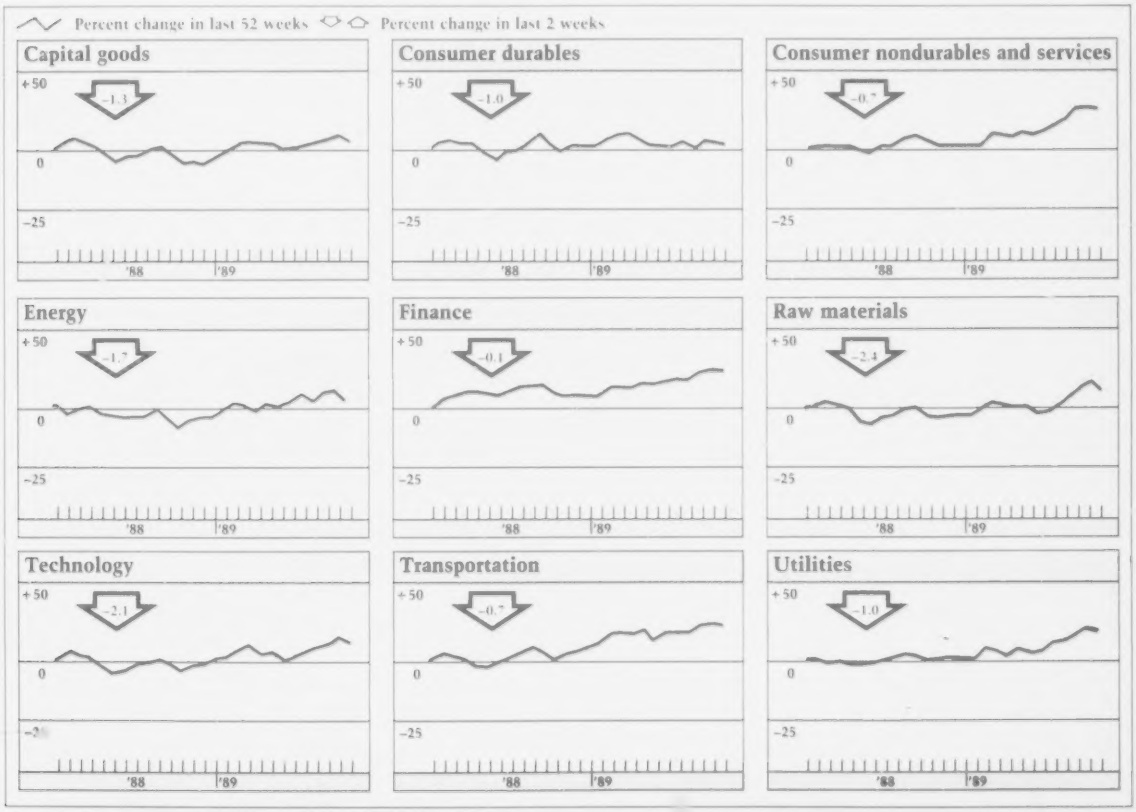
[1]Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created. [2]Based on sales. [3]Equal-weighted indices containing all shares with market capitalizations over $50 million. [4]Stocks's sensitivity to overall market movement. High volatility issues have wide price fluctuations; low volatility issues are more stable. [5]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 6/16/89. Prepared by Wilshire Associates, Santa Monica, Calif.

Where the Action Is

The battle for hearts, minds and shareholders exploded as media giants Time Inc., Paramount Communications and Warner Communications engaged in a complex merger war. In the last two weeks Time jumped 32% on Paramount's bid for the company. John Farrow, a Randolph Center, Vt. money manager, says, "Investors would be well advised to keep away from these stocks." Farrow thinks the original stock swap proposed by Time and Warner made sense. But he is afraid that Time's effort to fend off Paramount with a new leveraged buyout offer for Warner will produce a debt-burdened firm.

The big losers the last two weeks were technology stocks. Ashton-Tate and 3Com posted losses in excess of 23%, while Novell declined by 17%.



What the Analysts Think

Downbeat analysts. Wall Street forecasters downgraded eight of the nine Wilshire sectors in the last two weeks. Only the energy sector was spared. Transportation shares were hit the hardest. Ryder Systems' 1989 earnings estimate was lowered from $2.56 to $2.39, while the forecast for Sea Containers was trimmed 20 cents, to $5.12.

Forecasting the Forbes Sales 500

Performance period	Average earnings per share	P/E
latest 12 months	$3.35	12.9
1989 estimates	3.79	11.4
1990 estimates	4.16	10.4

Rank based on change in estimate	Sector	Estimated 1989 EPS	Estimated 1989 P/E	% change in 1989 estimate in 2 weeks	% change in 1989 estimate in 4 weeks
1	Energy	$3.34	11.6	0.78%	1.56%
2	Consumer nondurables	2.65	14.9	-0.10	-0.26
3	Utilities	3.02	11.6	-0.13	-0.19
4	Capital goods	2.99	13.2	-0.15	-0.21
5	Raw materials	3.46	9.4	-0.15	0.18
6	Finance	3.53	9.6	-0.31	-3.94
7	Consumer durables	3.52	10.8	-0.66	-0.40
8	Technology	3.19	11.5	-0.88	-1.54
9	Transportation	2.76	11.3	-1.25	-2.41

Earnings projections are capitalization weighted consensus estimates from over 3,000 security analysts. Data are compiled and updated continually by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York based brokerage firm.

Note: All data for periods ending in 1989. Prepared by Wilshire Associates, Santa Monica, Calif. IBES, a service of Lynch, Jones & Ryan, New York.